DEPARTMENT OF NATURAL RESOURCES

DIVISION OF OIL AND GAS

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Minerals Management Service
Royalty Management Program
Rules and Procedures Staff
Denver Federal Center
Building 85, P.O. Box 25165
Mail Stop 3101
Attn: David S. Guzy
Denver, CO 80225-0165

Reference: Request for Comments - Revisions to Federal Oil Royalty Valuation Regulations

Dear David:

In response to the request for comments, the State of Alaska, Department of Natural Resources is providing some suggested alternative royalty valuation methodologies for oil produced from federal leases. These methods could apply to all types of dispositions (i.e., arm's length sales, buy-sell arrangements, exchanges done at posted prices, etc.). We do not believe that posted prices are always a satisfactory indicator of oil value and other indicators of value need to be considered. These suggestions are based on the State of Alaska's experience in determining royalty value under specific lease terms and negotiated royalty value settlements.

We believe that the federal government should strive to receive the maximum royalty benefits from mineral resources on its land. Specifically, the royalty value should be the higher of:

1) Received Value (including all compensation and reimbursements to the lessee) determined per lessee's sales contract or agreement, or

2) Comparison Values determined from published data. These comparison values may be dependent on location (both production and sales), on selling arrangement, and on characteristics of the oil (such as gravity or sulfur content). Examples may include posted prices, spot prices, market basket prices, and NYMEX prices.

The characteristics of the Comparison Values, as well as the Received Value, are such that the lessee would be able to determine them by the royalty due date and thus report the "higher of" value. The lessee would not be dependent on the lessor providing these Comparison Values.

The agreement by both lessee and lessor to use specific published data which are available before the royalty due date, such as Comparison Values and contract values, could significantly reduce the effort expended to audit royalty payments and reach agreements on disputed royalty values.

The royalty value for Alaska North Slope (ANS) oil is based on market basket and published spot price values. These values are themselves dependent on destination (West Coast, mid-continent, Virgin Islands, or Gulf of Mexico), and are examples of Comparison Values. Attachment #1 is a brief description of the input data for each of these market baskets. Additionally, for your information attachment #2 is a description of the royalty provisions in the State's model oil and gas lease.

Alaska would be glad to participate in the formulation of new regulations to define the royalty values of oil from federal leases.

Sincerely,

Bill Van Dyke

Bill Van Dyke
Petroleum Manager

cc: Nancy Cress
Patrick Coughlin

Attachment #1

Market basket approach to deriving oil value:

While the 'highest of the four value measures' (described in Attachment #2) method was used as a basis to settle each lessee's past royalty obligations (i.e., 1977 to 1991), the ANS oil royalty value settlements between the State of Alaska and various lessees provide formula based methodologies to value oil for the present and future. The agreed methodologies for two of the three settlements establish oil values based on a netback formula using a predetermined weighting of seven publicly traded crude prices published in Platt's Oil Gram. The remaining ANS settlement, also uses a netback formula but uses only the published ANS West Coast spot price as the destination price as long as the ANS West Coast spot price is within plus or minus $.50 per barrel of the same seven West Coast market basket crude prices that is used in the other two settlement agreements. When the ANS spot price exceeds the plus or minus $.50 per barrel sideboard, then the market basket price is used in lieu of the ANS spot price. There are separate market basket formulas for the West Coast and the Gulf Coast. Sales to the Mid Continent and Caribbean are valued using an adjusted West Coast/Gulf Coast market basket price. All ANS oil royalty settlement agreements include a downstream transportation component. One settlement uses actual transportation rates while the other two use a formula as a proxy for actual rates. Because of the myriad of marketing arrangements that exist for ANS oil, the market basket and spot price approaches enable the State and its lessees to independently determine what the oil values will be from month to month for two of the three ANS settlements. In addition, the settlement agreements reduce the administrative and audit burdens associated with determining the royalty value.

Alaska's experience has shown that tracing individual premiums paid, contract terms and exchange transactions to determine a "fair value" for oil is difficult, time consuming, and may not always be cost effective. For these reasons, the State chose a formulaic, market-basket approach to follow to determine its royalty value. We believe that a market basket approach to establishing oil values provides a good alternative to determining what the royalty value should be.

Attachment #2

State of Alaska - Model Lease Oil Royalty Valuation Methodology

The State of Alaska's principal lease valuation concept for oil and gas comes from paragraphs 15 and 16 of the State's DL-1 lease form. These valuation concepts are under an "old" lease form and apply to old Cook Inlet leases. While most of the Alaska North Slope (ANS) leases are governed by the same "old" lease form, the ANS royalty settlement agreements have preempted the use of these valuation concepts. Alaska has used several other lease forms with different value provisions; however, little oil and gas have been produced from these leases.

Based on paragraphs 15 and 16 of the DL-1 lease form, four value measures are determined monthly and the highest value is used for royalty valuation purposes.

The four value measures are:

(1) The field market price or value at the well of all royalty oil and/or gas;

(2) The price actually paid or agreed to be paid to the Lessee at the well by the purchaser thereof, if any;

(3) The posted price of the Lessee in the field for such oil at the well, if any;

(4) The prevailing price received by other producers in the field at the well for oil of like grade and gravity at the time such oil is removed from said land or run into storage.

Value determination under value measure (1):

Under value measure (1) the royalty obligation is determined monthly by identifying the "field market price or value" of the oil at the point of production. Point of production means the automatic custody transfer meter or unit through which the oil enters into the facilities of a carrier pipeline or other transportation carrier. If, in any particular month, a significant number or volume of arms-length sales or exchanges take place at the point of production, those transactions comprise the principal basis for establishing the "field market price" for that month.

When there is not a significant number or volume of arms-length sales or exchanges at the point of production for any given month, the "value" of oil at the point of production is established by determining its value for that month in each destination market in which oil from a given field or area is sold or exchanged. Arms-length transactions are valued in each destination market and reasonable costs for transporting the oil from the point of production to that market are subtracted. "Value" signifies the worth or consideration received in dollars for the oil. "Value" is established for the oil of all lessees for that month in a given market. A separate value is established for each different destination because the value so determined can differ significantly depending on the destination market for the oil. Thus, a given lessee's total royalty obligation under value measure (1) will depend on the proportion of its oil disposed of in each market. The value determined in each market is based primarily on arms-length transactions, and includes all relevant evidence. Relevant evidence includes the circumstances surrounding the resource's disposition, the geographic location and characteristics of the oil disposition, and how each portion of oil is marketed.

Value determination under value measure (2):

Value measure (2) establishes a royalty floor for a month based on the monthly, third-party dispositions of the pertinent oil by the lessee in question. "Third-party disposition" means a disposition which is not an internal transfer. "Price" for purposes of value measure (2) refers to the full consideration received for oil in an arms-length transaction. If the dispositions do not occur at the point of production, a reasonable actual allowance for transporting the oil from the point of production to the place of disposition must be subtracted from the destination value. A lessee's royalty obligation under value measure (2) would be determined by looking at its third-party dispositions for that month's production of oil produced from the subject lease in all the geographic locations of those dispositions. Value measure (2) will not establish a royalty floor where there are no third party dispositions by a lessee but only internal transfers by that lessee.

Value determination value measure (3):

Value measure (3) establishes a royalty floor for a month whenever the lessee in question posts a price for the oil in the field during the particular month.

Value determination under value measure (4):

Value measure (4) establishes a "prevailing price" royalty floor for a month based on the weighted average price of all third-party dispositions of the pertinent oil in a given month, by all producers other than the lessee in question. The lessee would calculate its royalty obligation under this standard in any month whenever one or more of the producers in the field (other than the lessee) contract for third-party dispositions of oil produced from the pertinent field during that month without regard to where or when such dispositions occur. The "prevailing price" for each month is the weighted average price for all producers (other than the lessee) engaged in third-party dispositions for any portion of that month's production. "Price" for purposes of value measure (4) refers to the full consideration received in an arms-length transaction. No minimum volume of oil need be sold or otherwise disposed of, either monthly or daily, to establish a "prevailing price" under value measure (4). Value measure (4) will not establish a royalty floor for a lessee for any month for which there are no pertinent arms-length transactions by the producers in the field (other than the lessee) but only internal transfers by those other producers. The "prevailing price" is calculated for each month in which third party dispositions of a given field's oil occur, adjusted for actual, reasonable expenses incurred between the point of production and the market the oil was sold in.

Value measures (1), (2), (3) & (4) are theoretically applicable in every month to provide royalty floors for that month, although it is possible that in a particular month, no specific value can be determined under one or more of the measures.

Valuation standards-- arm's and non arm's length sales:

Royalty oil values for arm's length and non arm's length sales are based on the highest of the four value measures. Internal transfers and non arm's length sales are most often excluded from calculations to determine these value measures because they frequently exhibit few, if any, characteristics of market based transactions.

Other considerations:

As a general policy, the State of Alaska does not allow a transportation, cleaning or dehydration allowance for costs incurred upstream of the point of production; actual, reasonable transportation costs incurred between of the point of production and the point of sale are allowed. Various exceptions to the general rule can be found in the various royalty settlement agreements covering Cook Inlet and North Slope fields.

Certain deductions upstream of the point of production have been allowed from the royalty oil value under certain royalty settlement agreements between the State and its lessees. The types of expenses allowed under certain of these agreements are cleaning and dehydration charges, platform to shore transportation costs, processing costs, and gathering costs incurred upstream of the point of production.